No. 15120

In the United States
Court of Appeals
for the Ninth Circuit

UNITED STATES OF AMERICA,
Appellant,

vs.

THE UNITED STATES NATIONAL BANK OF PORTLAND (OREGON), Executor of the Estate of SAM J. WILSON, Deceased, and JESSIE WILSON,
Appellees.

On Appeal from the United States District Court for the District of Oregon

BRIEF FOR THE APPELLEES

C. E. WHEELOCK,
CARL E. DAVIDSON,
CHARLES P. DUFFY
Attorneys for Appellees.

FILED

SEP 21 1956

PAUL P. O'BRIEN, CLERK

GLASS-KEYSTONE PRESS

INDEX

TABLE OF AUTHORITIES
Decisions

UNITED STATES CODE

REGULATIONS AND RULINGS

MISCELLANEOUS

In the United States
Court of Appeals
for the Ninth Circuit

UNITED STATES OF AMERICA,
Appellant,
vs.
THE UNITED STATES NATIONAL BANK OF PORTLAND (OREGON), Executor of the Estate of SAM J. WILSON, Deceased, and JESSIE WILSON,
Appellees.

On Appeal from the United States District Court for the District of Oregon

---

BRIEF FOR THE APPELLEES

PRELIMINARY STATEMENT

This is an appeal by the government from a judgment of the United States District Court for the District of Oregon in an income tax refund action. The trial court determined that the sum of $437,783.53 in tax and interest had been improperly exacted from appellees and that it should be refunded to them.

After hearing the testimony, reviewing the numerous

exhibits and considering the authorities cited by the parties, the trial court determined (Tr. 37) that in January, 1943, (Tr. 191, 202), Samuel J. Wilson entered into an oral agreement of joint venture with one Samuel A. Agnew, by the terms of which they mutually agreed that Wilson would search for and examine various timberlands, locate the same and determine their suitability for purchase for later resale at a profit. It was mutually agreed that Agnew would furnish the necessary funds for the purchase of such timberlands as were selected by Wilson. It was further understood and agreed between them that all of said timberlands were to be sold within a reasonable time and that any profit resulting therefrom on timberlands acquired from any state, county or political subdivision of any state at a tax sale were to be divided equally between Wilson and Agnew, and that the profits derived from the sale of timberlands acquired from private owners were to be divided on the basis of 80 per cent thereof to Agnew and 20 per cent to Wilson. The agreement of joint venture was carried out until June of 1946. (Tr. 38).

In July, 1946, Agnew refused to recognize the interest of Wilson and the existence of the joint venture agreement. In July, 1948, Wilson instituted a suit against Agnew in Del Norte County, California, praying that the joint venture be established and that his interest in the timberlands be determined. (Tr. 39). After one day of trial, Wilson's claim of joint venture was compromised and settled by the transfer

to Wilson of certain timberlands (Tr. 39). The agreement was thereafter carried out in the year 1949 and in Wilson's income tax return for that year he duly reported the transaction as the nontaxable dissolution of a joint venture (Tr. 40). Wilson died on October 10, 1950.

The Commissioner of Internal Revenue determined a large deficiency in Wilson's income tax for the year 1949 upon the ground that the timberlands were not received by Wilson as the result of a dissolution of a joint venture but that the value of the timberlands constituted compensation for personal services performed by Wilson (Tr. 40). The executor of Wilson's estate paid the deficiency, plus interest, and when the refund claim was disallowed, this action was instituted.

APPELLEES' CONTENTIONS

Appellees' primary contention in this case is that no immediate tax was incurred by Sam J. Wilson in 1949 when the timberlands were conveyed to him in settlement of his litigation with Samuel A. Agnew. This is based upon what we believe to be a logical application to the facts of the following well recognized principles of law:

(1) That the taxable or nontaxable nature of the proceeds of litigation, whether as a result of a judgment or a compromise settlement, is determined by the nature of the basic claim of the party receiving such property; and

(2) That Wilson's basic claim in the Del Norte County proceedings was for a determination that a joint venture existed between him and Agnew and for a liquidation of its assets or a distribution thereof in kind; and

(3) That if a partnership or joint venture distributes its assets in kind, the partner or joint adventurer realizes no taxable gain or loss until he disposes of the property received in such liquidation; and

(4) That the conveyance of the timberlands to Wilson could not constitute a distribution of "profits" of the joint venture, as contended by the defendant in the trial court, because there were no profits to be distributed; and

(5) That the tax liability was postponed until such time as there was a sale or other disposition of the timberlands by the former joint adventurers.

ARGUMENT

The trial court found as a fact that Wilson and Agnew had entered into an oral agreement of joint venture (Tr. 37), just as Wilson had contended in the Del Norte County litigation (Tr. 38-39.) Appellees, however, were not trying to prove the existence of a joint venture, but were attempting only to show the nature of Wilson's suit against Agnew in order to establish the nontaxable character of the property received by Wilson in the settlement thereof. Although we

believe that the record shows (despite the fact that death prevented Wilson from so testifying) that a joint venture did in fact exist between Wilson and Agnew, we do not think that it was even necessary for the trial court to find in favor of the validity of Wilson's claim of joint venture because, as the Tax Court said in *Tygart Valley Glass Co. v. Commissioner,* 16 T. C. 941:

> "Though both parties have argued at some length as to the validity of each claim, we consider it unnecessary to decide upon such validity, as to either, for our question is not their validity, but the nature, for tax purposes, of an amount received in settlement, which rests not upon the validity but upon the nature of the matter settled."

There appears to be no split of authority on the proposition that the taxable or nontaxable character of property received in the settlement of litigation is to be determined by the allegations in the pleadings of the person receiving the property. *Lyeth v. Hoey, Collector,* 305 U. S. 188, 59 S. Ct. 155; *Helvering, Comm'r. v. Safe Deposit & Trust Co. of Baltimore,* 316 U. S. 56, 62 S. Ct. 925.

A great many decisions of the federal courts recognize this principle: *Raytheon Production Corp. v. Comm'r.* (CCA1) 144 F. 2d 110; *Jones v. Corbyn* (CCA10) 186 F. 2d 450; *Mathey v. Comm'r.* (CCA1) 177 F. 2d 259; *Durkee v. Comm'r.* (CCA6) 162 F. 2d 184. As the Court stated in *Farmers & Merchants Bank v. Comm'r.* (CCA6) 59 F. 2d 912:

> "The fund involved must be considered in the light of the claim from which it was realized and which is reflected in the petition filed."

The Tax Court of the United States has also followed this rule without exception: *Megargel v. Comm'r.,* 3 T. C. 238; *Tygart Valley Glass Co. v. Comm'r.,* supra; and *Albert J. Goldsmith,* 22 T. C. 1137.

We have found no cases which dispute this general proposition that the character or nature of the proceeds received in the settlement of litigation is to be determined by the nature of the claim which was thereby settled. There can be no serious doubt that in the Del Norte County litigation (Appellees' Exhibits 1, 2 and 3) Wilson was seeking to establish his alleged joint venture with Agnew and to obtain a dissolution thereof or a partition of the properties acquired as the result of his efforts since the early part of the year 1943.

The prayer of Wilson in the principal case (Appellees' Exhibit 2) was "That the joint adventure of plaintiff and defendant be established and plaintiff's interest in the above described premises, timber and timberlands be determined", and that Wilson's interest in the timberlands be either liquidated and sold or be divided in kind. An examination of the pleadings in Del Norte County case No. 4060 (Appellees' Exhibit 2) shows that prior to the date set for trial Agnew

filed a petition therein to limit the issue at the trial "to the question of whether or not a joint adventure was ever entered into between the parties hereto". The record of the first day's proceedings in the consolidated trial of these cases (Appellees' Exhibit 4) shows that the joint venture issue was the sole issue for determination by the Court at that time.

We do not believe that the Commissioner of Internal Revenue may re-examine the merits of the respective arguments of Wilson and Agnew in the Del Norte County proceedings, as these contentions were put at rest in the year 1949 when the parties entered into the settlement of their controversy and the timberlands were conveyed to Wilson in full satisfaction of his joint venture claim. It was not within the province of the Commissioner's representatives to determine arbitrarily that Wilson was wrong and Agnew was right in the Del Norte County litigation.

In the most recent case before The Tax Court on this question, the Commissioner of Internal Revenue conceded this general rule to be unquestioned:

> "The respondent (The Commissioner of Internal Revenue) does not challenge the proposition that if the payment in question was actually made in consideration of the dismissal of petitioner's suit, the income tax consequences would be determined by the nature of the grounds of the action which was thereby settled." *Goldsmith v. Comm'r.* supra.

The Commissioner of Internal Revenue has acquiesced in the Goldsmith case and, therefore, we shall not labor this point further, as the government should be prepared to concede the validity of this general principle. Numerous authorities are collected in annotations in 173 A.L.R. 558 and 101 A.L.R. 1453, and the rule is reiterated in *Merten's Law of Federal Income Taxation,* Section 5.21.

We turn, then, to the well recognized principle that if a partnership, or joint venture, distributes its assets in kind, the partner, or joint adventurer, realizes no taxable gain or loss until he disposes of the property received in such liquidation. This principle finds support in the statutes and regulations and should require no further citation of authority.

The pertinent part of Section 113(a)(13) of the 1939 Internal Revenue Code was as follows:

> "If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property."

Income tax Regulations 111, applicable to the years in question here, provided in part as follows:

> "If the partnership distributes its assets in kind and not in cash, the partner realizes no gain or loss until he disposes of the property received in liquidation." *Reg.* 29.113 (a)(13)-2.

The proper treatment of proceeds from the dissolution of such partnership or joint venture was amplified in an early ruling of the Treasury Department:

> "Where a partnership distributes any part of its assets in kind and a partner, in lieu of an undivided fractional interest in the whole, receives a full interest in a certain part of the assets distributed, such a change in interest does not constitute a closed transaction reflecting gain or loss. When, however, the property thus received by a partner is sold, any gain derived or loss sustained at the time of such sale will be measured by the difference between the selling price and the cost of the property to the partnership." *L. O.* 816, 1 *CB* 168

We believe that counsel for the government will agree that Section 731 of the 1954 Internal Revenue Code, relating to the extent of recognition of gain or loss on distribution of partnership assets, did not effect a substantive change in the law but merely codified the regulations and court decisions under the 1939 Code. Section 731 (a) (1) of the 1954 Code now provides:

> "(a) Partners.—In the case of a distribution by a partnership to a partner—(1) gain shall not be recognized to such partner except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution."

The stipulation for settlement of the Wilson-Agnew litigation (Appellees' Exhibit 5) provided, in effect, that, in

addition to the timber to be conveyed to Wilson, he was to retain the unexpended moneys which he had received from Agnew. Wilson's income tax return for the year 1949, (Appellant's Exhibit C), reported that he had paid in $36,-180.46 to the joint venture but had cash withdrawals of $54,700.00, leaving an excess of cash received over cash paid into the joint venture of $18,519.54. The effect of the retention of these moneys by Wilson was the same as a distribution of cash to him in dissolution of the joint venture. We submit that the dissolution of the joint venture was properly reported in Wilson's 1949 income tax return.

ANSWER TO APPELLANT'S ARGUMENTS

From the outset, the position of the Commissioner of Internal Revenue in this case has been as elusive as a wet bar of soap. The deficiency notice which initially prompted this litigation (Tr. 231, at 234) was based upon the contention by the Commissioner that the property was received by Wilson as compensation for personal services. In the trial court, however, that patently untenable basis was cast aside in favor of the alternative contention that the properties received by Wilson constituted his share of the profits of the joint venture. We then pointed out that there were no sales of any of the timberlands (Tr. 24) and, hence, no possible profits, and the trial court found as a fact that "The conveyance of

the timberlands to Wilson did not constitute a distribution of profits or anticipated profits of the joint venture" (Tr. 41). The government now pushes those rejected arguments in the background and argues, for the first time, that the property received by Wilson constituted "damages for loss of profits resulting from Agnew's alleged breach of the alleged oral joint venture agreement." (Page 22, Appellant's Brief). The pretrial order entered in the trial court shows that no such contention was made there (Tr. 26-7), and the government did not raise that issue below (Tr. 28). It is doubtful whether this contention is properly before this Court (*Cf. U. S. v. Carruthers,* CCA 9, 1955, 219 F. 2d 21, at 26; Rule 16, Federal Rules of Civil Procedure) but, in any event, we respectfully submit that this belated argument has no more merit than the earlier contentions of the Commissioner.

Before considering the general authorities cited in appellant's brief, we should note that the Commissioner of Internal Revenue in his regulations issued for the years in question here stated as follows:

> "The Internal Revenue Code provides its own concept of a partnership. Under the term 'partnership' it includes not only a partnership as known at common law but, as well, a syndicate, group, pool, joint venture, or other unincorporated organization which carries on any business, financial operation, or venture, and which is not, within the meaning of the Code, a trust, estate, or

a corporation. . . . . . . The following examples will illustrate some phases of these distinctions:

"(1) If A and B buy some acreage for the purpose of subdivision, they are joint adventurers, and the joint venture is classified by the Code as a partnership.

* * * * * * * * "*Regulations* 111, *Sec.* 29.3797-4.

CASES CITED BY APPELLANT

A. The appellant first argues that "The court below erred in concluding that a joint venture, rather than an employment relationship, existed between Wilson and Agnew" (p. 13, Appellant's Brief). Although the deficiency was asserted upon the ground that an employer-employee relationship existed between Agnew and Wilson, we believe that the government has, in fact, abandoned this position in favor of its current "damages for loss of anticipated profits" theory. This is understandable because even Agnew denied the existence of an employment relationship (Tr. 199, 200) and Agnew never claimed a deduction on his own income tax return for compensation paid to Wilson. He considered the settlement of the litigation as a division of the timber. (Tr. 219)

Appellant cites a number of cases to support its contention that "It is the general rule that among other essentials, there must be a sharing of losses as well as profits and a joint right of control." (p. 13, Appellant's Brief) Appellant cites three

early Oregon cases for the proposition that "in Oregon it is held that there must be a sharing of losses and that sharing of profits is not enough." (p. 15, Appellant's Brief) To the contrary, a more recent decision of the Supreme Court of the State of Oregon stated:

> "It is probably the law that an agreement, express or implied, to share losses is not essential to a joint adventure, especially in cases where one party furnishes money and other services." *Devereaux v. Cockerline,* 179 Or. 229 at 242, 170 P. 2d 727.

Appellant also cites the decision of the Washington Supreme Court, in *Gottlieb Bros. v. Culbertson's,* 152 Wash. 205, 209; 277 P. 447, for the proposition that "there must be a sharing of losses as well as profits". Despite this analysis of the Washington law by appellant, we turn to the opinion of this court in *Eagle Star Insurance Co. v. Bean* (CCA9, 1943) 134 F.2d 755, at 757, which states:

> "The elements of a joint enterprise, under the law of Washington, are stated in Carboneau v. Peterson, 1 Wash. 2d 347, 374, 95 P. 2d 1043, 1054, after a review of many of the Washington cases as '(1) a contract, (2) a common purpose (3) a community of interest, (4) equal right to a voice, accompanied by an equal right of control'. In view of the careful consideration given by the Supreme Court of Washington to their prior cases, we believe it is no longer the law of Washington that there is no joint adventure unless the parties

> agree, expressly or impliedly, to share the losses." (Citing many cases, including the *Gottlieb* case cited by appellant)

The California courts have also acknowledged recently that an agreement to share in the losses may be implied in any agreement of joint venture. *Fitzgerald v. Provines,* 102 Cal. App. 2d 529; 227 P. 2d 860, at 865.

Even though there is no requirement for a sharing of losses, as contended by appellant, we believe that the record shows that Wilson would have sustained substantial losses if the timber lands could not have been sold for a profit. Agnew stated repeatedly that he had paid Wilson nothing for his services in locating the desirable timber lands and arranging for their purchase. (Tr. 221). The recent comment of the Michigan court in *Summers v. Hoffman,* 341 Mich-686; 69 NW2d 198; 48 ALR2d 1033, seems pertinent in considering appellant's argument in the instant case:

> "With this contention we cannot agree. 'Loss' does not necessarily mean actual 'monetary loss'. If the land was eventually sold at a loss the result would be that plaintiff's expenditure of time would have been for nought as would defendant's monetary investment. If the title litigation had been decided adversely then plaintiff would have lost large out-of-pocket expenses and the value of the time which he had theretofore spent on the project which, while not quite as concrete or measurable as defendants' cash investment, is nevertheless a loss. It cannot be said that the plaintiff did not share any risk of loss . . . "

With reference to the requirement of joint control, we respectfully refer the court to the allegations in paragraph III of the amended complaint of Wilson in Del Norte County case No. 4060 (Appellees' Exhibit 2). Both Wilson and Agnew had joint control of the disposition of the timberlands, even though the legal title thereto was in the name of Agnew. As this court pointed out in *Eagle Star Insurance Co. v. Bean,* supra, the fact that one of the parties has entrusted actual control to the other does not negative the holding that there was a joint adventure.

Other cases on the question of what amounts to a joint venture are collected in an annotation in 138 ALR at 968.

In Elliott v. Murphy Timber Co., 117 Or. 387; 244 Pac 91, the Oregon Supreme Court stated:

> "A joint adventure is analogous to, but not identical with, a partnership. It has been defined as, 'An association of two or more persons to carry out a single business enterprise for profit' (Fletcher v. Fletcher, 206 Mich. 153), and is 'usually but not necessarily, limited to a single transaction, although the business of conducting it to a successful termination may continue for a number of years." 33 C.J., p. 842. 'This name seems to be applied to those special combinations of two or more persons, where in some specific venture a profit is jointly sought without any actual partnership or corporate designation. All such persons are partners or quasi partners, rather than joint or common owners; * * with essentially the

> rights and disabilities which pertain to the partnership relation, although less comprehensive or permanent in the scope intended.' "

We submit that the finding of the trial court that a joint venture existed was not "clearly erroneous". The basic inquiry in determining whether a partnership or a joint venture exists is the intention of the parties. *Commissioner of Internal Revenue v. Culbertson,* 337 U.S. 733, 69 S.Ct. 1210.

B. Lastly, appellant argues that "Even assuming that a joint venture existed, the court below erred in concluding that the settlement proceeds represented a property division rather than damages for loss of profits." (p. 22, Appellant's Brief).

It is noteworthy that the appellant here completely abandons its position in the trial court that the transfer of the timberlands to Wilson in settlement of the litigation constituted a distribution of profits. It is also noteworthy that the Del Norte County litigation was an equity suit and not a tort action for damages.

An increase in the value of assets over their cost does not constitute profits or taxable income. For example, if the A-B partnership acquires property for $35,000 and, over a period of time, the property attains a fair market value of $100,000, the partners do not realize any taxable income. If the partnership is dissolved and the property distributed in kind to the partners, there is no taxable gain to the partners or to the

partnership. Upon any subsequent sale or exchange of the property by the former partners, however, they must report the difference between their share of the partnership's basis of $35,000 and the selling price.

Wilson's contention in Del Norte County case No. 4060 (Appellees' Exhibit 2, Tr. 15-16) are to the effect that, pursuant to the joint venture between them, "Wilson would search for and examine timberlands suitable for purchase, such lands acceptable would be purchased, Agnew providing the funds necessary therefor; that lands so purchased were to be sold within a reasonable time for profit; that the profits realized from such sales, after deducting all sums advanced by Agnew with interest thereon at 5% per annum, were to be divided equally on tax title lands acquired from governmental sources and the profits were to be divided 80% to Agnew and 20% to Wilson on lands acquired from private owners" (Par. IV of Admitted Facts, page 3, Pretrial Order, Tr. 16).

It is readily apparent that Agnew was to be reimbursed, plus interest, for his disbursements before any profits were divided in the agreed proportions. Had there been any profitable sales during the existence of the joint venture, the cases relied upon by the government, such as *Parr v. Scofield* (CCA5, 1950) 185 F. 2d 535, would seem to have some application. Cf. *Commissioner v. Estate of Goldberger* (CCA 3, 1954) 213 F. 2d 82. There were no such sales, however, and no profits. What Wilson was receiving during

the life of the joint venture was an agreed share in the unrealized appreciation in the value of the timber. Such increment in value, however, did not constitute taxable income to the joint venture nor to either Wilson or Agnew upon dissolution thereof.

In 1949 Wilson's basis in the timberlands received by him in the settlement of the litigation, for the determination of the amount of gain or loss upon any subsequent disposition thereof, was zero. If, as contended by Wilson, there was a joint venture between them and it was voluntarily dissolved by them in the year 1949, there would have been no taxable gain at that time to either Agnew or Wilson. The fact that Wilson received his distributive share as a result of the compromise of the litigation cannot make taxable that which would have been nontaxable if received as a result of a voluntary dissolution of the joint venture and the distribution of its assets to the parties. *Jones v. Corbyn,* supra.

CONCLUSION

We respectfully submit that the timber and timberlands received by Wilson in settlement of the litigation constituted the distribution of property in the nontaxable dissolution of a joint venture, and the fair market value thereof did not constitute compensation to Wilson for his personal services, as originally contended by the Commissioner of Internal

Revenue; there was no distribution of profits of the joint venture, as contended by the government in the trial court, for the simple reason that there were no profits; and, finally, that the property received by Wilson was not in lieu of damages for lost profits.

The trial court in its findings of fact (Tr. 41) found that the settlement agreement of November 14, 1949, effected the dissolution of the joint venture theretofore existing between Agnew and Wilson and that the conveyance of the timberlands to Wilson did not constitute a distribution of profits or anticipated profits of the joint venture. In view of the foregoing, we submit that these findings of fact by the trial court were not "clearly erroneous" within the purview of Rule 52(a) of the Federal Rules of Civil Procedure, and that the judgment of the trial court is correct and should be affirmed.

Respectfully submitted,

C. E. WHEELOCK,

CARL E. DAVIDSON,

CHARLES P. DUFFY,

Attorneys for Appellees